

STATEMENT OF ROBERT GREENSTEIN
Executive Director, Center on Budget and Policy Priorities

Before the IRS Oversight Board
January 26, 2004

I am Robert Greenstein, Executive Director of the Center on Budget and Policy Priorities, a non-profit organization that conducts research and policy analysis on a range of budget and program issues, with emphasis on programs and policies affecting low-income families. The Center has been conducting analyses on issues relating to the Earned Income Tax Credit since 1984. We also have conducted for 14 years an outreach campaign, in which we provide outreach materials and training on the EITC to local government agencies, businesses, churches, service providers, unions, national, state, and local non-profit organizations, and community-based groups across the country so they may conduct outreach locally on the EITC. Some 2,000 state and local agencies participate in our outreach network. We have long worked closely with the IRS in this endeavor, and IRS staff often speak at our EITC training sessions.

We also have a long history of working to reduce errors and overpayments in low-income programs and to find ways to do so without deterring participation by eligible families. The first "quality control" systems were introduced into the Food Stamp Program and the School Lunch Program in 1980, at a time when I served as Administrator of the Food and Nutrition Service, the agency of the U.S. Department of Agriculture that operates the nation's food assistance programs. We have a strong interest in reducing EITC overpayments without harming eligible families. I appreciate the opportunity today to present our views to the IRS Oversight Board and would like to address issues related to efforts to reduce noncompliance in the EITC.

In response to a February 2002 IRS study of errors in EITC claims for tax year 1999, an internal task force of IRS and Treasury officials was charged in 2002 with developing recommendations to reduce EITC overclaims. Unfortunately, the way in which those recommendations were developed and initially acted upon was problematic; public participation was denied in this process, and the procedures that were initially recommended and approved have serious shortcomings that resulted in sharp criticisms of the IRS in the media and on Capitol Hill. The original recommendations, set to be implemented as policy in the summer of 2003, were untested procedures that represented major departures from how other individual and business tax returns are treated and that posed serious risk of causing injury to substantial numbers of eligible low-income filers.

Since last spring, under Commissioner Everson, the IRS has begun to take a much more positive approach to soliciting ideas on testing and evaluating approaches to determining EITC eligibility and controlling erroneous claims. The new IRS Director of the EITC Program, David Williams, the National Taxpayer Advocate, Nina Olson, and the departing Assistant Secretary for Tax Policy, Pam Olson, have played helpful roles in this regard. Major progress has been made. We remain concerned, however, about some significant potential problems in this area.

The Overly Secretive Development of the Pre-Certification Procedures

The deliberations and even the membership of the IRS and Treasury task force on the EITC remained secret for more than a year. There was no public process to provide suggestions or commentary to the task force in the development of its recommendations.

Finally, in March 2003, the IRS began inviting organizations with which it had partnered on EITC outreach, low-income taxpayer clinics that are involved in resolving low-income taxpayer disputes, and members of several IRS advisory committees to review the task force's plan for EITC "pre-certification." The tone of the meetings with stakeholders appeared, however, to be more one of selling the necessity of the pre-certification policy (which stakeholders were told was not open for discussion) than one of inviting participation in the design of its concept and structure. There was some discussion of the IRS organizing "working groups" of stakeholders to work with IRS staff in developing operational details of aspects of the procedure, but such a process was never initiated.

The initial IRS plan for pre-certification was to begin with a random selection of 45,000 taxpayers who claimed the EITC in the 2003 filing season and who fell within certain categories of claimants that the IRS considered to be at higher risk of submitting claims with errors related to the residency or relationship of the qualifying child. These taxpayers were to receive notices in the summer of 2003 asking them to submit documentation, by December 31, 2003, that the children they intended to claim for the EITC in the 2004 tax filing season had lived with them for more than six months in 2003. The notices also would require taxpayers among the selected group who were not parents or adoptive parents to document their relationship to the child being claimed. Taxpayers who did not submit the required documentation, or who submitted documentation that did not satisfy IRS examiners, would be denied the EITC.

The IRS indicated it planned expansion of pre-certification to two million EITC claimants in the summer of 2004 and a subsequent further expansion to all claimants that met the profile selected for pre-certification, including new filers. This would affect between 20 and 30 percent of all EITC filers, impacting perhaps four to five million taxpayers each year.

Early Lack of Opportunity for Public Comment

The IRS briefings of stakeholder groups in March 2003 indicated that no formal public comment process was planned either for the pre-certification procedure or for the two new IRS forms that taxpayers selected for the procedure would be required to complete. (It subsequently emerged that OMB had earlier provided IRS a waiver permitting it to implement the new procedure and forms immediately, without a prior public comment process.)

Furthermore, the IRS appeared at that time to have no detailed plan regarding how pre-certification would be evaluated. Nor was it evident how the IRS would achieve its stated goal of preventing EITC overclaims without causing eligible taxpayers either to be deterred from filing EITC claims as a result of the burdens of the new procedure or to be denied the EITC because they could not produce documents that satisfied IRS examiners.

Of particular concern, the IRS declined to characterize the first-year implementation of pre-certification as a "pilot test." The new procedure was apparently limited to 45,000 claimants in

2003 primarily because of concerns that the unit newly formed to process pre-certification documents could be overwhelmed with a larger first-year implementation, but the IRS indicated it planned to subject two million filers to these procedures by the summer of 2004 despite the fact that meaningful evaluation results from the initial year of pre-certification (particularly on the effects on *eligible* families) would not be available by that time.

Public Comment Process and Change of Direction

After major concerns about the pre-certification procedure and the lack of a public comment period were expressed by stakeholder groups, members of Congressional committees that oversee the IRS, and the media, the IRS relented and announced a 30-day comment period in June 2003. In its announcement of the comment period, the IRS indicated it intended to implement pre-certification by sending notices to selected taxpayers in August 2003 rather than in July. IRS also announced it had decided to drop the relationship component of the pre-certification procedure — and the highly controversial new form that had been designed to verify the relationship of the taxpayer and child claimed for the EITC. By this time, the difficulty and, in some cases, the impossibility of taxpayers being able to comply with the requirements set forth on that form had been extensively documented.

This comment period was not announced through the Federal Register, but only through an IRS news release. In addition, the IRS never subsequently announced its procedure for public examination of the public comments it received. Efforts by some stakeholders to review the comments that had been submitted — a standard practice in other agencies across the federal government — were unsuccessful.

Having made these critical remarks, I should note that since June, the IRS has changed course, made a number of beneficial decisions in this area, clearly considered the comments it received, and begun to work more closely with stakeholders. The eventual IRS decision on implementing EITC pre-certification looks quite different than the plan the IRS initially proposed to institute in July 2003.

In August 2003, the IRS announced that due to the many useful suggestions provided in the public comments, it no longer planned to implement pre-certification during 2003. Since the IRS needed additional time to incorporate suggestions into the design of the residency form and related third-party affidavit, it announced that instead of requiring selected taxpayers to comply with an eligibility verification procedure *in advance* of filing EITC claims, the IRS would send "certification" notices in December 2003 to a pilot group of taxpayers, requiring them to submit documentation of their residency with a qualifying child *at the same time* they submitted their tax returns and claims for the EITC, during the 2004 tax filing season. Another factor in IRS' decision to defer implementation until the tax filing season apparently was IRS' concurrence with stakeholder concerns that taxpayers who had to respond to notices in the summer or fall would not be able to receive assistance from commercial tax preparers or Volunteer Income Tax Assistance (VITA) sites that they normally use in filing their tax returns, since most such offices would not be open during these months. An adequate alternative assistance plan for these filers was not in place.

The IRS also announced a reduction from 45,000 to 25,000 in the size of the group of taxpayers selected for certification, since the larger number exceeded what was necessary to pilot-

test the procedure. This reduction in numbers also may have been intended to help the IRS unit handling certification to avoid becoming overwhelmed and to avoid lengthy delays in processing returns and providing refunds.

The Certification Pilot Test

The IRS now explicitly describes EITC certification in the 2004 filing season as a pilot test. The IRS also is including, as part of the pilot, a test of two different versions of the third party affidavit. This responds to comments urging the IRS to test different approaches and techniques to assess which provide the best results.

The IRS decision to require additional documentation of eligibility to be submitted during the tax filing season, rather than in advance, means the initial pilot test differs in some important respects from the original idea of pre-certification of eligibility. The original idea has not been abandoned; the IRS has indicated that it intends to test pre-certification during the summer and fall of 2004.

Uncertainties about the Plan to Evaluate the Pilot Test

The IRS plans to undertake an evaluation of the pilot. As part of the evaluation, it will be critical for the IRS to be able to determine both whether certification is effective in reducing EITC receipt by *ineligible* filers and whether taxpayers who are *eligible* for the EITC are deterred from claiming it or are denied the credit as a result of the certification procedure.

We commend the IRS for consulting stakeholder organizations and experts on evaluation techniques on what elements should be included in the evaluation of the certification pilot and for contracting with Mathematica Policy Research, Inc. to review the plan for the pilot and to make recommendations regarding it. But major concerns regarding the evaluation remain. In particular, it is unclear whether the evaluation will, in fact, provide solid information on the extent to which those who cease receiving the EITC as a result of the new procedures are eligible or ineligible.

In a report that the GAO issued on the new procedures, the GAO discussed the IRS' plan to contract with an outside evaluation firm to survey taxpayers who have failed to respond to the notice to certify their eligibility for the EITC, or have dropped out during correspondence with the IRS, or have been denied the credit because IRS found their documentation insufficient. The GAO indicated that it was its understanding that the contractor would not assess the eligibility or ineligibility of those whom it contacts. In the more recent report on the evaluation that was prepared for the IRS by Mathematica Policy Research, the Mathematica researchers raised concerns about how effective the evaluation will be in determining the degree to which those who are deterred or denied are eligible or are ineligible. The researchers made a series of important recommendations to the IRS regarding how to address this matter. The IRS is now considering these recommendations.

The concerns that we and others have about this matter are, in part, a reflection of the serious problems that have emerged in the IRS' EITC "Recertification Program." For the past several years, families that have applied for the EITC but been denied it for certain reasons have been required to be *recertified* by the IRS before they are permitted to resume receipt of the EITC

in subsequent years. In tax year 1998, some 119,000 filers who claimed the EITC were required to recertify. (These data come from a GAO report on EITC recertification.¹)

In a report issued in April 2002 and in Congressional testimony on May 7, 2003, the GAO found serious problems in recertification. It determined that some eligible EITC filers who were subject to recertification were asked to provide documents that it was not possible for them to secure and that some filers provided documents that IRS notices asked them to provide, only to have IRS examiners reject those documents as inappropriate. The GAO also found widely inconsistent rulings by IRS examiners. In its May 2003 testimony, the GAO reported: “we noted that IRS examiners did not consistently assess documentation for qualifying children. For example, we asked 21 examiners to examine five EIC scenarios. The 21 examiners did not agree on any of the scenarios, and, in some cases, the examiners reached widely varying judgments about whether the evidence was sufficient to support an EIC claim.”²

The GAO emphasized in this testimony that the documentation requirements for the pre-certification initiative bear similarities to the documentation requirements used in recertification; the GAO cautioned that similar problems could arise in pre-certification. The GAO also noted that the tasks of IRS personnel who will handle the new pre-certification procedures appear similar to the tasks of IRS examiners who handle recertification. This raises concern about how IRS examiners will handle the documents that families that are subject to the new certification and pre-certification procedures provide.

The GAO’s findings on recertification suggest that a significant share of the filers subjected to recertification who fail to make it through the recertification process — and thus are barred from receiving the EITC — may be eligible for the EITC. This adds to concerns about whether this will also be true of the EITC certification and pre-certification procedures. It underscores the importance of the evaluation in providing hard data on this matter.

In this regard, we believe it is very important for the IRS to adopt the various recommendations that Mathematica has made to it regarding how to strengthen the evaluation, including the Mathematica recommendations for how the IRS can get sounder evaluation data on how effective the new procedures are in preventing EITC receipt by *ineligible* filers and the degree to which the procedures cause *eligible* filers to lose benefits.

Recommendations for the Next Pilot Test

Although a final decision hasn’t been made, it appears likely that the IRS will proceed with a pilot test of EITC pre-certification in the summer of 2005. We have several recommendations to make regarding the plan for this next pilot test.

- Last spring, the IRS said that pre-certification forms would be provided in English and Spanish. This fall, however, the IRS reversed course, providing the forms only in English in the current certification pilot. The certification forms contain a line in

¹ General Accounting Office (GAO-02-449).

² Statement of Michael Brostek, Director, Strategic Issues, General Accounting Office, “Compliance and Collection: Challenges for IRS in Reversing Trends and Implementing New Initiatives,” (GAO-03-732T), May 7, 2003.

Spanish, at the top of the forms, providing a phone number that filers can call to receive the forms in Spanish. In announcing this decision in the fall, the IRS said it would mail the forms in both English and Spanish to 1,000 of the 25,000 filers in the EITC certification pilot and would examine, as part of the evaluation, whether directly providing the forms in Spanish increased response rates among Spanish-speaking filers.

Unfortunately, this aspect of the pilot and evaluation has turned out to be deeply flawed. The examination of the evaluation plan that Mathematica prepared under contract with IRS found that this part of the pilot and evaluation will essentially have no value — Mathematica showed that it simply is not possible for this aspect of the pilot and evaluation to provide valid results, and that essentially nothing will be learned about whether providing the forms in only one language, with a Spanish reference to a phone number to call for Spanish forms, results in lower response rates among Spanish-speaking families. Mathematica also indicated that it is virtually impossible to design a pilot of this type in which one can secure valid results on this matter.

Mathematica also reported that “a recent study of the use of dual language instruments to obtain mail responses from Spanish-speaking Medicaid enrollees found that responses were 16 percentage points higher among those who received the dual language instrument compared to those who did not.” This is a very large effect.

Since the certification pilot will not produce meaningful results on this matter and we have a strong indication from the Medicaid study that providing the forms in both languages makes a substantial difference, we strongly recommend that in designing the EITC pre-certification pilot that is likely to start next summer, the IRS go back to its original plan in this area and mail the pre-certification forms in both English and Spanish.

- When IRS officials discuss the prospects of a pre-certification pilot test, they frequently mention a pilot group of 45,000 or 50,000 taxpayers. Since the IRS found that 25,000 was an adequate sample size for the certification pilot — a finding that the Mathematica analysis confirmed — we do not see a justification for doubling the size of the test group for the pre-certification pilot that the IRS has indicated it intends to conduct next summer and fall. The same number of filers — 25,000 — should be ample to secure valid results in that pilot, as well.
- The IRS should hold firm to the approach of testing the effect of these procedures. No decision to expand the application of these procedures to larger numbers of filers should be made until results of the evaluations of these pilot tests are in, including their effects on eligible filers.

Finally, we have noted in other analyses (and in the box on page 8 of this testimony) that the IRS study of overpayment rates in 1999 does not reflect changes in the law made since then. Of particular note, the 2001 tax legislation gave the IRS authority, starting January 1, 2004, to use

“math error authority” to deny EITC claims by filers who show up in the “National Case Registry” (a national child support database that the federal government maintains) as being the *non*-custodial parents of the children they are claiming for the EITC. This approach is aimed at getting at some of the same problems as pre-certification — the claiming of children for the EITC by filers who are not eligible to claim them.

This new authority is controversial. The National Taxpayer Advocate opposes it; she believes some of the data in the Registry is outdated and thus should not be used as a basis for math error authority denials. The IRS has not yet made a decision as to whether to use this authority. It has focused more attention on certification and pre-certification.

The key point here is that it is unclear which would be more efficient and effective in preventing EITC receipt by ineligible filers — the math-error authority or pre-certification. It is equally unclear which approach would deter participation by eligible filers the least.

As a result, we believe the IRS should pilot test use of this math error authority as well. Having results from pilot tests of *both* approaches should enable sounder decisions to be made about whether to move forward with pre-certification, whether to use this math error authority, whether to use neither procedure, or whether to adopt a combination of both approaches.

The Focus on the EITC and Low-Income Taxpayers

The IRS should be encouraged to provide more accurate and up-to-date estimates of EITC errors. More information also is needed on the degree to which EITC errors are errors that are *not* specifically related to the EITC, but rather are the reflection within the EITC of *system-wide* errors — such as errors that occur when self-employed individuals and small business proprietors underreport their income. An analysis by EITC experts in Treasury’s Office of Tax Policy found, for example, that one of the leading causes of EITC errors is underreporting of income and that the *majority* of the EITC overpayments that are due to income underreporting stem from underreporting by self-employed and small business people, despite the fact that returns from such individuals represent only a relatively small fraction of all EITC returns. This suggests that much of the EITC overpayment in this area is due not to problems in the EITC itself but to a larger problem in tax compliance generally.

Indeed, in testimony before the House Ways and Means Committee last year, Leonard Burman, Senior Fellow at the Urban Institute and co-director of the Urban-Brookings Tax Policy Center (and a former deputy assistant secretary for tax analysis at Treasury), observed: “it is likely that much EITC noncompliance reflects compliance problems that are endemic to the entire income tax. If that is true, then targeting compliance activity at EITC participants alone may not be the most effective use of IRS resources.” Also of note, Nina Olson observed in her 2003 Annual Report to Congress that over ten years ago, “...the IRS estimated that nonfarm sole proprietor income accounted for \$16.9 billion in underreported income. This number dwarfs the 1999 \$9 billion EITC overclaims, yet the IRS has no significant strategy to address this serious tax administration problem.”

Finally, most measures the IRS has instituted to control EITC error, including the certification pilot, reflect an attempt to better regulate the behavior of low-income taxpayers. This

What Is the Level of EITC Overpayments?

As analyses by the Center on Budget and Policy Priorities have explained and as the National Taxpayer Advocate has noted, IRS's study on EITC overclaims in 1999 may overstate the rate of EITC errors in 1999. It almost certainly overstates the *current* error rate.

That study estimated that the EITC overpayment rate in tax year 1999 was between 27 percent and 31.7 percent and placed the overpayment amount at between \$8.5 billion and \$9.9 billion. This range reflected the fact that a significant fraction of families selected for the study did not respond to the IRS when contacted. This is a typical occurrence when studies of this nature are conducted in means-tested programs, and past evaluations in other means-tested programs have found that many people who do not respond in such circumstances actually are eligible for program benefits but are intimidated by the request, do not understand the request (due to literacy problems or lack of fluency in English), or simply wish to avoid the hassle. For example, two USDA studies of families whose children lost free or reduced price school lunches because the families failed to respond to a request for verification found that more than 80 percent of the non-responders were actually eligible for free or reduced-price lunches.

The 27 percent EITC overpayment rate estimate — the low end of the range in the IRS study — assumes that overpayments occurred at the same rate among the non-responders as among those who did respond. The 31.7 percent overpayment rate assumes that all of the non-responders were ineligible for every dollar of EITC benefits they received. The 31.7 percent figure, which represents the upper bound of the range, clearly overstates the true error rate in 1999.

But the 27 percent rate also may have overstated the error rate in 1999. Nina Olson, the National Taxpayer Advocate, has pointed out that the experience both of her office and of low-income taxpayer clinics shows that when the validity of EITC claims is being challenged by the IRS, an interactive process involving numerous contacts with low-income taxpayers whose claims are being questioned is often necessary to clarify that a claim that IRS officials initially believe to be erroneous is, in fact, valid. The IRS study of EITC overpayments in 1999 did not provide for a sufficient process of this nature, she has explained. This may have resulted in premature judgments in some cases that EITC payments were made in error.

The National Taxpayer Advocate's report to Congress issued in December 2002 explains that "Taxpayers often obtain completely different (favorable) results from the original IRS determination" when they receive assistance from the Taxpayer Advocate Service in EITC audits and other IRS actions challenging EITC claims. The Taxpayer Advocate's report noted that Taxpayer Advocate Service (TAS) assistance resulted in reversals of IRS rulings in 51 percent of the EITC audit cases in which the TAS was involved in fiscal year 2002. The report further explained that "TAS intervention often involves helping the taxpayer understand what documentation is needed and then working with the taxpayer to find alternative ways of substantiating an EITC claim."

This suggests that some portion of the EITC claims classified as being erroneous in the IRS study may have been valid claims for which the tax filer, operating without assistance from a knowledgeable party, could not provide documentation that satisfied the IRS within the timeframes the IRS allowed. In a subsequent report to Congress, issued on June 30, 2003, Olson stated that for these reasons, she believes the 1999 study "overstates the overclaim rate."

Finally, Congress has made substantial changes in the EITC since 1999. Changes in the EITC made as part of the 2001 tax legislation significantly simplified the EITC in various respects; and analysts in Treasury's Office of Tax Policy have estimated that the 2001 statutory changes may reduce EITC overpayments by \$2 billion a year. Earlier this month, the Treasury announced a further set of EITC simplification proposals, which it will present to Congress as part of the President's budget next month. Those simplification measures should result in further reductions in EITC errors, if enacted.

focus should be broadened; since about 70 percent of EITC claims are filed using commercial tax preparers, efforts should focus on preparers, as well. IRS data show that error rates among returns filed by commercial tax preparers are as high as errors on self-prepared returns. There has been little attempt, however, to reduce what appear to be problems in EITC return preparation by private preparers. Few preparers receive even the small fines that can be levied for failure to exercise “due diligence” in submitting accurate claims for the EITC.

We believe a system for greater accountability and training of preparers should be developed. The National Taxpayer Advocate has recommended such a system; we believe her recommendations merit serious consideration. In this vein, we would note that EITC claims submitted by preparers who are not CPAs or enrolled agents have been found to have substantially higher rates of overpayment than EITC claims made on returns submitted by other types of preparers. This strongly suggests that more training and regulation, focusing on such preparers, might reduce EITC errors. Efforts such as this may hold promise to reduce errors and overpayments without harming eligible filers, which is everyone’s goal.